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# International Economic & Energy Weekly

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13 June 1986

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# International Economic & Energy Weekly [redacted] 25X1

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# International Economic & Energy Weekly

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1 **Perspective—Seoul-Washington Trade Talks** 25X1

After six months of quiet, behind the-scenes diplomacy, US–South Korean trade negotiations will move back into the spotlight during the annual bilateral trade talks on 23-24 June. Seoul is bracing for tough talk from Washington on access to the South Korean market for goods and services and renewal of South Korea's benefits under the Generalized System of Preferences. 25X1

3 **Eastern Europe: Economic Impact of Chernobyl'** 25X1

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17 **Gaza and the West Bank: Recession Sets In** 25X1

The economies of the West Bank and Gaza are feeling the pinch of the recession in Israel, Jordan, and the Persian Gulf states. Economic growth has stagnated, unemployment has increased, and remittances from abroad have declined. Growing joblessness, especially among educated Palestinians, may portend additional political problems in the West Bank. 25X1

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# International Economic & Energy Weekly [redacted] 25X1

13 June 1986

**Perspective**

## *Seoul-Washington Trade Talks* [redacted] 25X1

After six months of quiet, behind-the-scenes diplomacy, US–South Korean trade negotiations will move back into the spotlight during the annual bilateral trade talks on 23-24 June. In the plus column, Seoul has met nearly all of Washington's demands under unfair trade practice actions by offering greater access to South Korea's insurance market and better protection for intellectual property rights. Nonetheless, Seoul is bracing for tough talk from Washington on:

- ***Access to the South Korean market for goods and services.*** Seoul is likely to resist speeding up import liberalization and more equitable national treatment for foreign banks, as well as lowering barriers to competition by foreign airlines and air cargo services. Progress on the politically charged issue of Seoul's ban on beef imports is unlikely even though they admit their policy violates GATT rules. The South Koreans have nevertheless signaled a willingness to compromise on imports of US cigarettes and personal computers, issues on which the United States had hinted it might invoke stern trade actions.

- ***Renewal of South Korea's benefits under the Generalized System of Preferences (GSP).*** Because of Korea's growing international competitiveness, economic policy makers are resigned to total graduation from GSP in the next five years. Short-term continuation of these benefits, however—which apply to only 17 percent of Korea's exports to the United States—is politically important. Loss of GSP would affect primarily the small- and medium-sized firms the South Korean Government is trying to foster. [redacted] 25X1

We expect South Korean negotiators to press for expanded landing rights in the United States for Korean Air Lines (KAL), preferential military sales credits, and fewer restrictions on third-country sales of defense goods incorporating US technology. Seoul regards landing rights in Chicago as a quid pro quo for intellectual property protection and insurance market access. Seoul probably will also express support for a new GATT round with the proviso that trade in services be considered separately from goods. [redacted] 25X1

Although resolution of the insurance and intellectual property rights cases has been Seoul's highest priority [redacted] 25X1 25X1 these issues may not be resolved completely before the talks begin. The insurance case is settled, but technical problems on patent protection linger, interfering with Seoul's plan to announce simultaneous withdrawal of both trade actions. According to the US Embassy, the government is seeking to minimize domestic protests over concessions to Washington and may withhold its announcement until July when vocal student critics will be on vacation. [redacted] 25X1

On balance, however, conditions favor Seoul's keeping up the momentum for solving bilateral trade problems in the near term:

- Trade negotiators, in our judgment, are now convinced that the United States is serious about using tough measures to open South Korea's markets. The insurance and intellectual property rights cases raised domestic acrimony over trade issues to new heights, and Chun realizes that continued trade problems are a political liability.

- Import liberalization is closely tied to current account performance—Seoul is projecting a $500 million surplus this year, the first in nine years and its first-ever trade surplus. South Korea is also enjoying the benefits of the three "blessings": low oil prices, low interest rates, and a strong yen. Strong economic growth this year—the government forecasts 8-percent real GNP gains—will help appease businessmen who oppose market opening. [redacted] 25X1

Despite these positive factors, the political situation and some persistent financial problems will continue to limit Seoul's room to maneuver on trade issues:

- South Korea's economic technocrats cite the unsettled political scene as a major constraint to progress on trade issues, and there is plenty of evidence to support their case. Opposition politicians are pressing demands for revision of the constitution to make the presidential election in 1988—when Chun has promised to step down—more democratic. Because radical student and labor activities this spring often featured anti-US themes, liberalizers will be careful in responding to requests from Washington.

- The large foreign and domestic debt will also limit Seoul's willingness to make trade and investment concessions that would hurt the already low profitability of domestic firms. To fuel its economic miracle, South Korea ran up a $47 billion foreign debt—the third largest among LDCs. In addition, South Korean firms are saddled with some of the highest debt burdens in the world. The Korean banks that made many of those loans are technically insolvent, although we believe the government will continue to bail them out. [redacted] 25X1

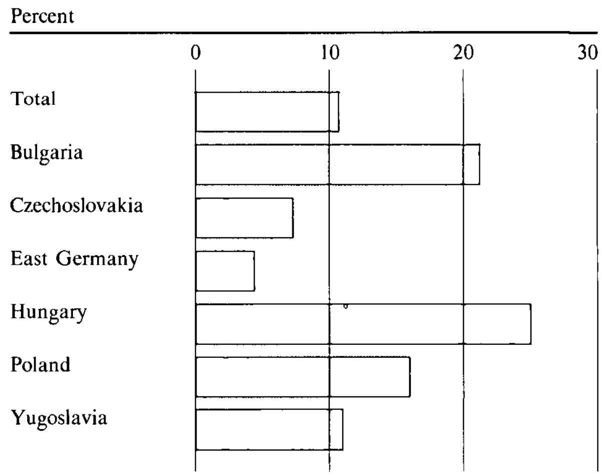
[redacted] 25X1

# Eastern Europe: Economic Impact of Chernobyl' [redacted]

25X1

The accident at Chernobyl' already has hurt the East European economies, particularly by depressing hard currency earnings. We anticipate that these losses, which stem from Western reluctance to purchase East European agricultural products, will persist at least until the end of this year. Other economic costs have been minimal so far but could mount, especially if Moscow shunts some of its costs associated with Chernobyl' onto Eastern Europe. [redacted] 25X1

**Eastern Europe: Food Products as a Share of Exports to the Developed West, 1984**




[redacted] 25X1

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## Export Prospects Damaged

Lost hard currency earnings, already exceeding $100 million, constitute the main cost so far of the Chernobyl' accident to Eastern Europe. The European Community's now-expired ban on imports of dairy products, fruit, vegetables, fresh meat, and live animals from the East European countries (except East Germany),[1] similar import restrictions still being enforced by other countries, and ongoing consumer fears have cut into the region's agricultural sales. Even some nonfood exports, such as textiles and toys, reportedly have been refused in the West because of possible contamination. [redacted] 25X1

We estimate that hard currency export losses could mount to $600 million in 1986, about 3 percent of the region's sales to the developed West. The losses would fall most heavily on Hungary, Bulgaria, and Poland, which depend on agricultural products for a significant share of their hard currency earnings. As a result of this weakened trade performance, Yugoslavia and Bulgaria's deficits would swell, and Hungary and Poland's surpluses would decline considerably. [redacted] 25X1

We believe adverse publicity and rumors concerning the safety of East European food will continue to depress Western demand at least through the end of this year. Many regimes probably fear that the EC's plan to continue testing food products until September 1986—despite the lifting of the import ban—may frustrate efforts to retain or recapture market shares. These regimes have expressed concern that the EC is using Chernobyl' as a front for protectionism. Western importers also may balk at the extra cost and effort to buy from Eastern Europe. [redacted] 25X1

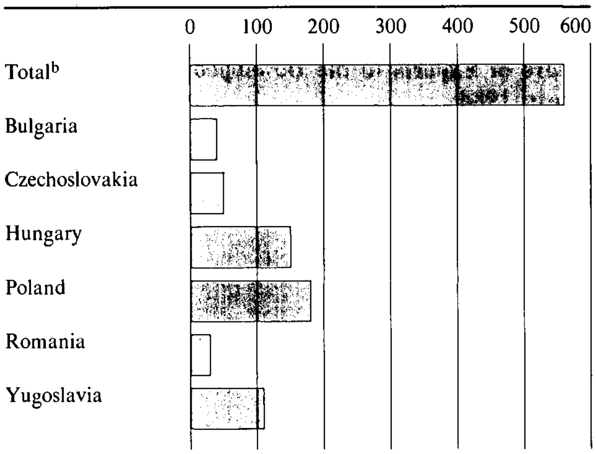
## Other Hard Currency Earnings Also Depressed

Fears of radiation and contaminated food have dashed hopes for a boom year in tourism. Adverse

[1] Bonn has guaranteed that East German goods transiting West Germany to EC markets meet West German health standards. [redacted] 25X1

**Eastern Europe: Drop in Hard Currency Trade Balances, 1986[a]**

Million US $




[a]Estimated. Assumes each country loses one-fourth of its food exports to the Developed West as a result of the Chernobyl' incident.
[b]Data excludes East Germany.

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publicity has dampened Western tourism in Eastern Europe, while checks for radioactivity have contributed to costly delays in transportation. Hungary, Poland, and Yugoslavia have all cited canceled bookings, and Budapest estimates the cost at $20 million. The Poles have complained that Western inspections of its ships and canceled port calls have reduced transport earnings. Other countries probably have experienced similar problems. 25X1

**Uncertain Impact on Agriculture and the Consumer**

We believe the effect on agricultural output will be minimal except perhaps in Romania and Poland—recipients of the highest radiation doses. So far, the main impact has been the ban on grazing in several countries, which has increased dependence on stored—or possibly imported—feed. As of mid-May, Poland, Czechoslovakia, and Bulgaria had purchased additional soybean meal as a result of the accident. 25X1 Also, dairy industries have been affected; cows can produce hazardous milk for about two months after extended eating of contaminated feed. Although winter grains planted last fall should be safe, leafy vegetables could have been exposed to contamination. 25X1

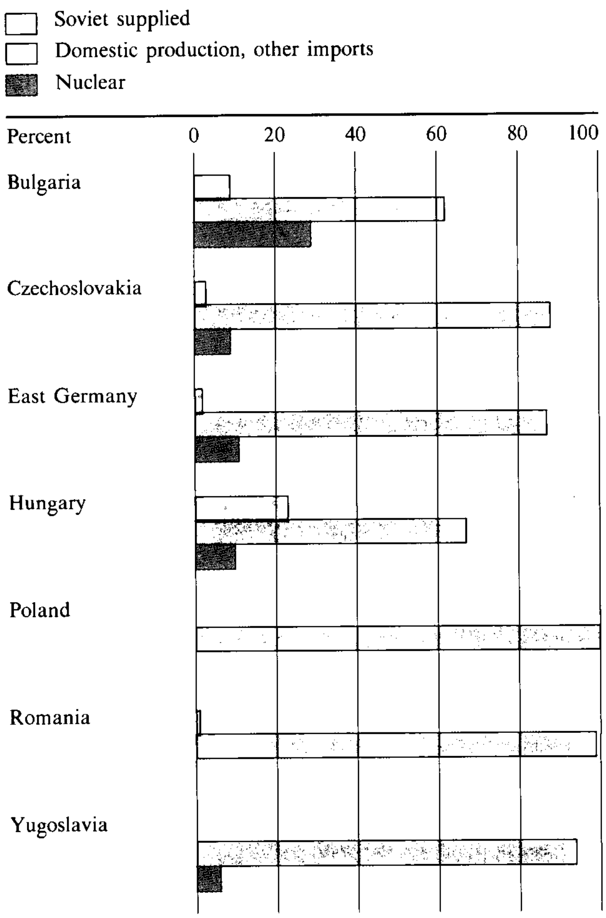
The accident initially hurt consumer supplies somewhat in Eastern Europe. The press reported milk shortages in some countries, as dairy products were removed from stores. Consumer resistance is causing a domestic glut of fresh vegetables, but the hoarding of canned goods is contributing to spot shortages. The situation may reverse next spring if consumers shun canned goods processed this year and opt for fresh vegetables. Consumer expenditures on health products, services, and medicines to counteract contamination almost certainly have risen. 25X1

**Limited Impact on Domestic Energy Supplies**

So far, the Chernobyl' accident has had marginal impact on Eastern Europe's domestic energy supplies. Only the Hungarians have mentioned a small decline in electricity imports from the USSR. The timing of the accident—while energy demand is at a seasonal low and hydropower generation at a seasonal high—has provided a cushion against possible cuts in Soviet exports of electricity. Nonetheless, as seasonal demand increases after the summer, we believe that the Soviet power industry may be unable to cope with the loss of the Chernobyl' plant solely by boosting thermal generation and shifting power from other areas of the USSR. Any sizable power shortfall would not happen before the fourth quarter when demand will be more than 20 percent higher than now and East European energy supplies are typically tight. 25X1

Disruptions in electricity deliveries from the USSR would affect the individual East European economies differently. Soviet deliveries comprise less than 4 percent of overall electricity supplies in most East European countries. Hungary and Bulgaria 25X1

**Eastern Europe: Sources of Electricity for Domestic Consumption, 1984**

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are the exceptions, depending on the Soviets for nearly 25 and 10 percent of their electricity, respectively. However, these countries have access to the CEMA and Austrian power grids, and we believe reductions in Soviet deliveries would be spread out to minimize the impact on any one country. Moreover, an improved energy situation in Eastern Europe as a result of a less severe winter than the previous one, increased domestic production, and opportunities to buy low-priced oil in the West bode well for the region's ability to absorb any Soviet electricity cutbacks. 25X1

### Costs to the Nuclear Programs

The Chernobyl' disaster is unlikely to erode the commitment of most East European countries to nuclear power—CEMA recently approved a nuclear program to the year 2000. The regimes have long viewed nuclear energy as a clean, virtually inexhaustible power source, and as a path toward energy self-sufficiency. Most of these governments have publicly vowed to continue their nuclear programs, reiterated the advantages of nuclear power, and emphasized the safety and advanced technology of their own reactors. Yugoslavia, however, has already postponed two nuclear plants, and, according to the US Embassy in Bucharest, Romanian President Ceausescu claimed that his country would rethink the construction of additional reactors. 25X1

In the wake of Chernobyl', we believe Eastern Europe is likely to adopt additional safety measures that will boost the cost of nuclear power. Possible measures include: locating nuclear plants farther from heavily populated areas; designing new plants with additional safety features; and maybe turning to the West for some equipment and, in extreme cases, entire plants. As a result, nuclear construction programs might be delayed because of increased costs and public anxiety over nuclear safety. 25X1

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### Who Will Pay?

Western refusal to buy East European food may have some side benefits:

- Eastern Europe could increase food exports to the USSR and consequently reduce its soft currency debt to Moscow. Eastern Europe has been pressed by Moscow to pay its debts by exporting higher quality products.

**Nuclear Reactors in Eastern Europe**


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- If the USSR does not absorb all of the food rejected by the West, East European consumers could benefit from better and more plentiful supplies than are now available. [redacted] 25X1

Eastern Europe would bear additional costs if Moscow attempts to share the burden of the Chernobyl' disaster with the region. For example, the USSR could demand that Eastern Europe provide workers, materials, and technology—possibly imported from the West—to help in the cleanup effort. If electricity losses in the USSR were greater than estimated, Moscow could decide to divert some oil exports to the region to domestic thermal power plants or to sell it in the West to earn additional hard currency. Moscow could press Warsaw to increase deliveries of coal for use in Soviet power plants. [redacted] 25X1

On the other hand, the East European countries that have suffered losses as a result of the Chernobyl' accident most likely will try to recover some of their lost revenue from the USSR. [redacted] 25X1 The press has speculated that President Ceausescu asked Moscow to make up Romanian losses, [redacted] 25X1 Although many of the regimes may press the USSR to import agricultural products on a hard currency basis, Moscow, with its own financial problems, is unlikely to provide complete compensation. In turn, we believe some countries may use the costs incurred by the accident as an excuse for not meeting their economic commitments to the USSR. Financially strapped Poland, Romania, and possibly Yugoslavia also may try to shift some of their losses to the West using the disaster as a reason to reschedule existing debts and possibly obtain new credits. Poland and Romania are already using the loss of exports as an excuse for not meeting payments to Western creditors.

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[redacted]

## Peru: Shortcomings in Garcia's Economic Program 25X1

President Garcia's economic measures have paid some early dividends in terms of reduced inflation and faster economic growth, but these benefits are likely to be short lived. The initial phase of his program, which included a freeze on prices and the exchange rate, brought inflation down from a 250-percent annual pace in mid-1985 to 40 percent late in the year. Stimulative measures implemented in October and February helped boost GDP this year, but at the cost of rekindled inflation and a widening budget deficit.

Garcia continues to view economic problems primarily in political terms, favoring labor over business to mollify militant leftist unions. He has granted generous wage increases while holding down prices, and made it extremely difficult to fire workers. This pattern probably will continue, causing a reduction in profits, production, and investment, and boosting inflationary pressures. With most Peruvian workers inured to economic hardships, however, the economic deterioration should not be severe enough to damage Garcia politically this year. If present trends continue and Garcia's attempt to generate a homegrown economic expansion falters, he may ease his confrontational stance with foreign creditors to foster an increased inflow of development capital.

### Garcia's Economic Program

When Garcia took office last July, he set ambitious goals for the Peruvian economy. His first priorities were to stabilize prices and gain control over monetary policy by reducing the use of the dollar in the economy. He dramatized his broader goal of boosting domestic production by announcing that Lima would limit its debt service payments to 10 percent of export earnings over the coming 12 months and conserve these funds for development.

The initial measures included a "shock therapy" similar to what Argentina had undertaken two months before and what Brazil underwent early this year. Wage increases provided the only stimulus during this phase, and this was offset partly by increases in public utility rates. Consumer prices, which had been rising an average of 11 percent per month in mid-1985, rose at only 3 percent during the final months of the year. The government discouraged domestic use of the dollar by setting much lower interest rates for dollar accounts compared with those on local currency accounts, and by actively buying up dollars on the financial market. 25X1
Moreover, Garcia held the budget deficit in the last quarter of 1985 to 4 percent of GDP—no worse than achieved during the rest of the year—and avoided overheating the economy. 25X1

Economic distortions created by the initial measures were apparent by early fall. High real interest rates, which had been set by Lima, forced retailers and wholesalers to reduce their inventories. Faced with higher costs—for salaries, utilities, and imported inputs because of the initial devaluation—and a price freeze, producers increasingly diverted goods to the black market. 25X1

Except for some tinkering with the program, the biggest changes came this February when Garcia launched the "reactivation" phase. He boosted 25X1
consumer purchasing power by allowing workers 15- to 30-percent wage increases, cut interest rates on loans to below the rate of inflation, and slashed the sales tax. He gave business a break by cutting industrial utility rates, by establishing a fund to rescue ailing firms, and by allowing exporters to convert a larger share of their dollar earnings at market rates. Furthermore, Lima granted price increases for certain basic consumer goods, augmenting selective price increases granted in previous months. The government also announced a target of 5- to 7-percent real GDP growth for 1986, 25X1
compared with the 1.5-percent gain reported last year. 25X1

***Garcia's Economic Program***

***Phase I (August 1985)***
*The currency is devalued by 12 percent, and the exchange rate frozen against the dollar. The name of the currency is changed from sol to inti, with the inti equal to 1,000 soles. Dollar certificates of deposit are frozen for 90 days, although certificate holders are permitted to convert these to intis. The interest rate on inti certificates is set initially at 73 percent, whereas dollar accounts return only 8 percent. Interest rates on loans are cut to 110 percent, while deposit rates are set at between 40 and 80 percent.*

*Public utility rates are raised 20 to 35 percent, producer prices for food are increased, and the military budget cut. Public-sector salaries are boosted 15 to 22 percent, and the minimum wage is increased 50 percent. Wages and prices are then frozen.*

*Payments on the foreign debt are limited to 10 percent of export earnings over the next 12 months; later, this is defined as a $320 million maximum. Import controls expanded.*

***Phase II (October 1985)***
*The 4-percent payroll tax is eliminated, and employers directed to pass the savings on in the form of a salary increase.*

*Spending on small regional projects is increased.*

*Banks, insurance, and mining companies are required to buy government bonds in an amount equal to 40 percent of 1984 profits.*

*The share of export earnings that can be converted at the market rate is raised from 15 to 20 percent.*

***Phase III (February 1986)***
*Public worker salaries are raised 25 to 28 percent, nonunion workers are permitted increases of 15 to 25 percent, and the minimum wage is raised by 30 percent. The sales tax is cut from 11 to 6 percent.*

*The interest rate on loans is dropped to 40 percent; the rate on deposits reduced to 7.5 percent.*

*Electricity rates for businesses are cut by 10 to 20 percent, kerosene prices are reduced 10 percent, and road transport rates reduced 12 percent.*

*Exporters may convert up to 30 percent of their earnings at the financial rate.*

*Government establishes a $220 million fund for agricultural development and price supports.*

*Price increases of 5 to 9.6 percent are granted for a few basic commodities.*

[redacted] 25X1

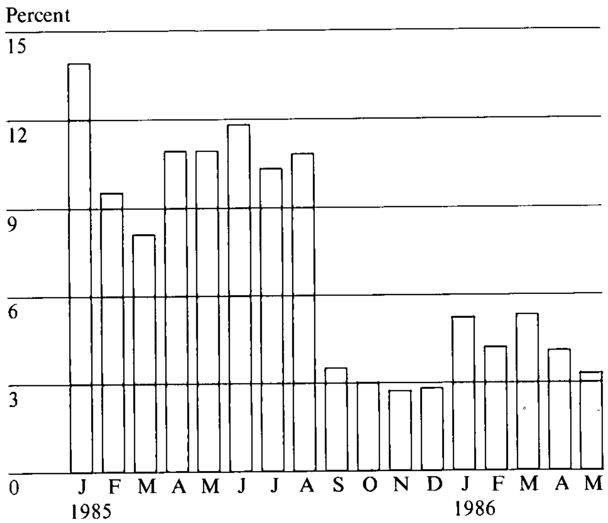
Lima already has claimed success for its reactivation efforts. In June, the government announced that GDP had risen 2.9 percent in the first quarter of 1986 in comparison with the final quarter of 1985. The increase was led by a 10-percent boost in manufacturing output, which the press indicates was based largely on heightened demand for consumer durables. Peruvian officials are confident that the resurgence in inflation will subside, according to the press. Recent public statements suggest that no new domestic economic policy measures are under consideration for the near term. [redacted] 25X1

**Problems Ahead**

Although economic successes may be buoying the confidence of Peruvian policymakers, several trends suggest that further progress will be difficult to achieve:

- Removal of the payroll tax and the big cut in the sales tax will slash government revenues; independent forecasters expect the public-sector deficit to reach 11 percent of GDP this year.

**Peru: Monthly Inflation Rate Trends, 1985-86**




[redacted]

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**Peru: Share of GDP by Sector and Sector Growth Trends**

*Percent*

| | Share of GDP 1984 | Growth Rate 1984 | Growth Rate 1985 |
|---|---|---|---|
| **GDP** | **100.0** | **4.5** | **1.5** |
| Services | 43.2 | 4.5 | 1.7 |
| Manufacturing | 24.7 | 2.5 | 3.4 |
| Mining | 10.9 | 6.4 | 5.2 |
| Government | 9.8 | 0 | −1.0 |
| Agriculture | 7.8 | 8.4 | 2.9 |
| Construction | 2.9 | 1.5 | −13.2 |
| Fishing | 0.5 | 89.1 | −6.7 |

[redacted] 25X1

- The combination of high wage increases—the minimum wage has risen 95 percent under Garcia—and minimal price hikes will squeeze business profits.

- Strikes have become more prevalent as Communist-dominated unions seek to confront Garcia; the 25- to 30-percent wage increases granted to public workers on 1 June will embolden unions, representing other sectors of the economy, to achieve similar increases.

- The freezing of the exchange rate puts manufactured exports at a disadvantage at a time when depressed world prices have already diminished Peru's export earnings from metals and petroleum.

- Increasing violence by Peru's two major insurgent groups—the Sendero Luminoso and Tupac Amaru (MRTA)—has caused major firms to increase spending on security to the detriment of investment, according to a local economic journal. [redacted]

Garcia will face strong pressures from Peruvian business interests to ease price controls. According to the US Embassy, the government may soon abandon the eroding freeze and replace it with regular price adjustments. In addition, exporters are seeking a devaluation to boost the sagging sales of Peru's nontraditional manufactured exports and to increase revenue from commodity exports in terms of domestic currency. Business will probably also ask Garcia to take a firmer hand with the unions, but without much success. Although he has become increasingly unsympathetic toward unions because their members are the highest paid laborers, he still seeks to defuse confrontations with organized labor by allowing wage increases that exceed inflation. [redacted] 25X1

Despite a mushrooming budget deficit, there is no indication that Garcia is ready to come to grips with this issue. The recent public-sector wage increase suggests that he will not cut back government spending. [redacted] he also is determined to push ahead with public works projects in the poorer regions and plans to continue emphasizing aid to farmers in the Andean plain and eastern regions—important areas in the current counterinsurgency strategy. Neither are there any indications that he intends to reverse his steady reduction of the tax burden. [redacted] 25X1

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## Outlook and Implications

All trends point to a resurgence in inflation in the coming months as Garcia grants further wage and price increases, expands subsidies and credits to domestic producers, increasingly turns to money creation to finance the budget deficit, and eventually yields to a devaluation. The US Embassy believes Peru probably will adopt a multiple exchange rate—which Garcia could use to mask the amount of devaluation. As a result, Peru could see inflation return to triple digits by later this year. [redacted] 25X1

In spite of mounting problems, we do not anticipate a rapid deterioration of the economy this year. Because of the healthy first-quarter performance, Peru's GDP may grow 3 to 4 percent in 1986. We do expect production to stagnate later this year, however. Garcia's political opponents—who are mainly on the left—might become emboldened by an economic slowdown, but his personal popularity is so high—in the 70- to 80-percent range—that we do not foresee economic problems as a major political concern in the near term. [redacted] 25X1

As his economic options narrow—and the trade surplus dwindles—Garcia may moderate his dealings with foreign creditors. This trend is already suggested by recent payments to the IMF, the US Government, and commercial banks. Garcia may decide that Peru cannot achieve the growth and modernization he seeks without greater recourse to external resources. We doubt he will moderate his rhetoric given his continuing aspirations to act as a spokesman for the Third World—especially on the debt issue—but he may make new payments to the IMF and commercial banks if he can point to a net gain of foreign capital. [redacted] 25X1

[redacted] 25X1

# Syria: Uneven Domestic Impact of Economic Crisis

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Syria's economic crisis is beginning to hurt all segments of society, but the Assad regime seems unwilling to take the necessary steps to reverse the decline. Ineffective economic policies and heavy military expenditures have exhausted government finances, and the black-market crackdown in January has constrained Syria's strong underground economy. The impact on the population of commodity shortages and surging inflation has been uneven, with fixed-income workers hit the hardest. Although economic problems place new pressures on the regime, we believe Syria's strong and ruthless internal security apparatus, combined with extensive price subsidies on food staples, will contain popular unrest for the time being.

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## Economic Conditions Worsening

The Syrian economy, in terrible shape for the past five years, has taken a sharper downturn in the past six months. An expanding military budget—over half of current expenditures in 1985—and shrinking domestic output since 1982 have wrecked government finances. Foreign exchange reserves—estimated at no more than $200 million—have limited imports. Shortages of necessities have forced consumers, businesses, and even public-sector companies to rely on smuggled goods, which deprive the government of vital foreign exchange. According to the US Embassy, the bulk of Syrian imports now come through illegal channels. In the past six months, purchasing power has eroded drastically as prices have risen by up to 100 percent. There are several reasons for the economy's inflationary spiral:

- At one point in January, the Syrian pound fell by 30 percent in offshore and illegal markets, which raised prices for most imports.
- Official prices have been allowed to rise as subsidies become too costly.
- Embassy reporting indicates some hoarding in anticipation of further price increases.

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Foreign aid payments from oil-exporting donors have fallen off with the slackening of the oil market and general Arab dissatisfaction with Damascus's regional policies. Periodic Iranian cutoffs of oil shipments over Syria's failure to pay have forced Damascus to purchase crude oil for its refinery operations on the spot market, cutting further into its foreign exchange. Compounding Syria's financial problems, worker remittances from the Gulf states have fallen by about one-third since 1982.

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## The Government's Response

The Syrian Government has taken a few steps to shore up domestic finances and reverse the decline of the pound. In late January, the government—panicked by the pound's 30-percent drop in one month—arrested 1,500 moneychangers to reduce speculation and restrict capital flight. In March, the government intensified its crackdown by closing 154 shops in Damascus for dealing in smuggled goods and other illegal activities. In addition, Prime Minister Kasm issued a decree—almost certainly endorsed by Assad—prohibiting imports from Lebanon and tightening border controls to restrict travel of private citizens to Lebanon. The decree was probably aimed at pressuring the recalcitrant Lebanese Christians who profit from illegal exports to accept the Syrian-sponsored Tripartite Agreement, but the result was to curb imports vital to Syria's economy. To cut government subsidies and restrict consumption, official prices on domestic products and legal imports such as tires, steel, fuels, sugar, and coffee have been raised, but no increase in food staple prices has been announced.

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Economy Minister 'Imadi has tried to stimulate the private sector, but his influence is limited by the traditional Ba'th Party establishment led by Kasm.

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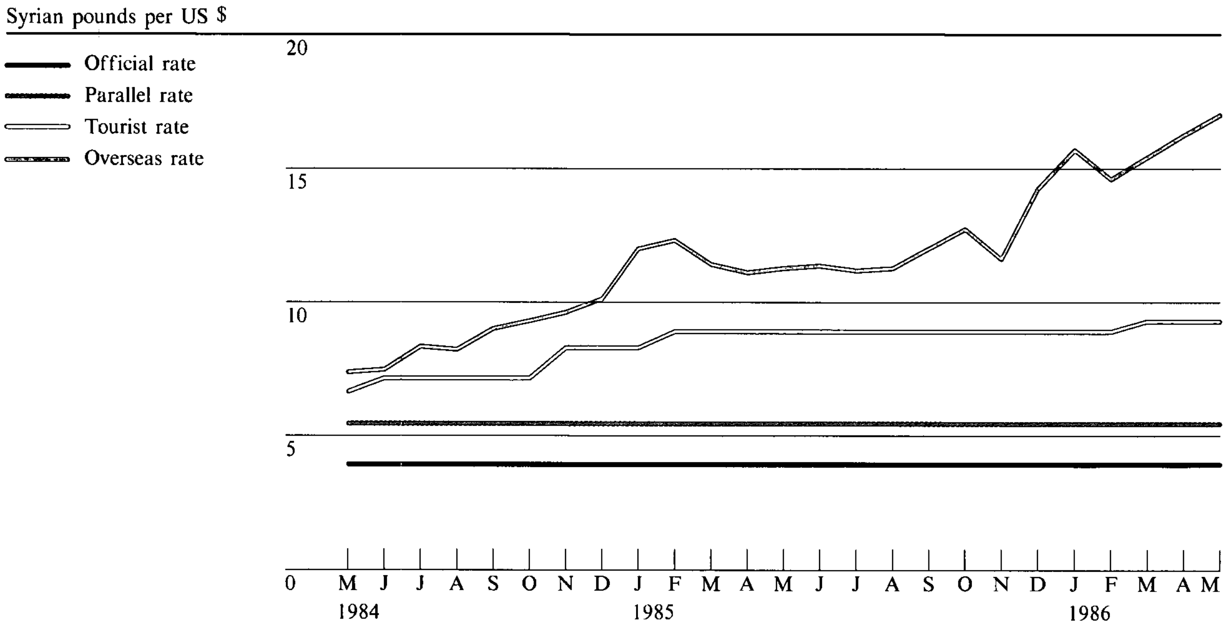
**Syria: Exchange Rate Structure,1984-86**

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'Imadi has devalued the tourist exchange rate and shifted most legal commercial transactions to the parallel rate to stimulate exports. In addition, he allowed agricultural export earnings to be redeemed at the tourist rate, giving farmers a higher return. Despite his good intentions, 'Imadi's reforms have made little impact; Assad's support is necessary for any major policy shift and thus far he has shown no sense of urgency. The economy is a low priority for Assad, and reform is usually limited to vague calls for greater "sacrifice" and ending "corruption."

### The Uneven Squeeze

Syria's economic crisis has touched all segments of society, but its effects have been uneven. Shopkeepers, artisans, and low-level government workers with few means of supplementing their incomes have been hurt the most. Even the privileged groups whose support is crucial to the regime—businessmen, bureaucrats, and especially the military—have not been insulated. 25X1

We believe residents of *Damascus* have suffered disproportionately especially from the surging inflation. Bitterness is increasingly apparent in the capital as both consumers and businesses face a shortage of vital imports. The housing shortage has worsened and will continue in the near term as building projects are suspended for lack of government funds. Even President Assad's palatial residence near Damascus remains unfinished. In addition to sewage, water, and transportation problems, electricity in the city is shut off for three or more hours a day.

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Government workers—mostly based in Damascus—and others with a fixed income have lost purchasing power. The US Embassy reports that inflation averaged 10 to 20 percent annually since 1983 before accelerating over the past six months. Meanwhile, public-sector employees received 10- to 25-percent pay increases in late 1985—their first in five years. [redacted]

The *urban population outside Damascus* has probably fared better. Like Damascus, the larger cities—Latakia, Aleppo, and Homs—depend on imports, but there is apparently less concern with inflation, and the black-market crackdown may be less intense than in Damascus. Moreover, outside Damascus, a larger share of the population works in the private sector and has greater autonomy to raise prices and wages to offset inflation. Nonetheless, many commodities in short supply in Damascus are practically unobtainable in other cities. In our view, this is partly due to the capital's higher priority for the distribution of goods. In addition, consumer goods smuggled from Lebanon are less likely to reach cities farther from the border, such as Aleppo. In northern Syria, economic problems are exacerbated by severe shortages of water and electricity. [redacted]

The *military elite* who supplement their income by controlling smuggling out of Lebanon have had their activities largely curtailed in the recent crackdown. We believe they will use their position and influence to circumvent and undermine controls on the black market. The US Embassy in Damascus reports that Assad's crackdown was criticized by elements in the Security Services. In addition, some members of the Syrian High Command believe the reforms may cause problems with the senior military officers who control smuggling, according to a [redacted]

The small class of *wealthy Syrians* has also been hit by government measures to conserve foreign exchange. In February, air fares increased 61 percent and the automobile sales tax increased 400 percent. In addition, there was speculation over a similar increase in real estate taxes and a higher exit fee—equivalent to $90—for Syrians traveling abroad. [redacted]

The *rural poor* have probably been hurt the least by the recent downturn; they are less dependent on imports than the urban population and less affected by inflation. Moreover, many in the countryside have benefited over the past decade from extensive government irrigation projects, rural electrification, and roadbuilding. As a result, the rural poor probably remain an important base of support for the Ba'th Party and strong backers of the Assad regime. Projects aimed at expanding the infrastructure and improving living conditions in the countryside also help stem the flow of population into the cities. [redacted]

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**Assad's Position Still Secure**

Despite increasing criticism of the regime's economic management, Assad's internal position remains strong. Popular indignation has been directed instead at the military, police, and Ba'th officials, as well as those who control smuggling and feed off public funds. Economy Minister 'Imadi also faces growing criticism for his apparent role in the price increases. [redacted] 25X1

Despite his strong position, Assad is conscious of the potential for political unrest. For the near term, we believe Assad will remain content to call for greater austerity rather than risk the political fallout of economic reform. The much-needed exchange rate realignment has been approached very slowly, probably because of its inflationary potential. Syria's pervasive internal security apparatus makes major public protests unlikely. Bread prices, nevertheless, are kept low through extensive subsidies. [redacted] 25X1

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Threats to Assad's power from the military and police resulting from the economic crisis, in our judgment, are slim. The military leadership engaged in smuggling is probably content to ride out Assad's recent crackdown until smuggling inevitably resumes its former level. Assad's biggest challenge from the military and its large network of profiteers will come if economic constraints force him to cut the military budget and reduce arms purchases. The US Embassy in Damascus reports

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that for now Assad is resisting any cutbacks in military spending. We believe Assad is so determined to achieve strategic balance with Israel that the Syrian leader will do his utmost to avoid cutting military expenditures. 25X1

**Outlook**

We believe Assad will take additional limited steps to spur the economy but will hold to Syria's traditional socialist policies. Efforts to reform the economy and free the private sector will probably fall short as entrenched military leaders and bureaucrats fight to retain privileges. Recent oil discoveries in eastern Syria will be insufficient to erase the regime's economic problems. 25X1

Syria's economy will probably continue to deteriorate over the next year. The black market and moneychangers will doubtless remain integral to the Syrian economy. The net effect of the crackdown has been to erode confidence in the government, stimulating capital flight. Although the worsening economic situation could prompt unrest among several groups, expectations of most of the population remain low. Assad's hold on the government and military is firm, and the security forces are strong enough to repress dissidence. 25X1

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## Gaza and the West Bank: Recession Sets In [redacted] 25X1

The economies of the West Bank and Gaza are feeling the pinch of the recession in Israel, Jordan, and the Persian Gulf states. Economic growth has stagnated, unemployment has increased, and remittances from abroad have declined. High unemployment is particularly troubling, especially in light of the possible return of more Palestinian workers from the Persian Gulf states. Jordan is preparing a new five-year development plan for the West Bank, but its impact on the territory is likely to be small because Amman's economic difficulties leave it only meager funds to spend across the Jordan River. Growing joblessness, especially among educated Palestinians, may portend additional political problems in the West Bank. [redacted]

### Continued Economic Decline

A recent survey by the Bank of Israel states that real GDP growth in the West Bank and Gaza averaged only 1 percent per year from 1983 to mid-1985.[1] GDP per capita suffered a substantial decline, however, since the population growth rate during this period was estimated at 2.9 percent per annum and outward migration to the Persian Gulf countries dropped considerably. [redacted]

Deteriorating trade balances were a major factor in the economic stagnation. Total exports from the territories—almost two-thirds going to Israel and one-third to Jordan—declined 22 percent in 1984 due, in large part, to a falloff in sales of Gaza products. Exports probably fell further last year, but at only a fraction of the decline suffered two years ago. Imports to the territories—90 percent from Israel—also declined in 1984, but at one-half the rate of the fall in exports. Imports last year were probably at about the same level as 1984. [redacted]

[1] Although the economies of the occupied territories are intricately linked to that of Israel, the Bank of Israel tries to maintain separate statistics for the West Bank and Gaza. Because these statistics exclude the activities of Jewish settlements in the territories, they reflect, at best, the trends in the Palestinian sectors of the economies. [redacted]

Earnings of dayworkers in Israel constitute an important source of income for the territories and contribute to the healthy surplus in services trade with Israel. This surplus totaled $281 million in 1984, but declined to $206 million last year—a reflection of the austerity program in Israel that caused an erosion of real wages and a cutback in the construction industry, in which many West Bank and Gaza Palestinians work. [redacted] 25X1

Another source of income—remittances from Palestinians working abroad—also has declined in recent years as have other unilateral transfers such 25X1 as Jordanian funds to West Bank municipalities and money provided by the PLO to both the West Bank and Gaza. A recent Bank of Israel study estimated that worker remittances alone fell about 5 percent in the period from 1983 to mid-1985. We believe the decline in remittances has been even greater during the past year. [redacted]

### Unemployment Becoming a Major Problem 25X1

According to Israeli statistics, unemployment on the West Bank increased from 3.7 percent in 1984 to 5.3 percent for the first nine months of 1985. 25X1 Some 85,000 people from the territories now work in Israel as day laborers, a 7- to 10-percent decline from the number employed two years ago. These workers comprise approximately one-half of the total labor force of Gaza and about 30 percent of the labor force of the West Bank. Some [redacted] 25X1 [redacted] estimate unemployment at closer to 10 25X1 percent for 1984. Unemployment in the Gaza area is usually 1 to 2 percentage points below that of the West Bank. [redacted] 25X1

Unemployment among the professional ranks, especially academics, is a particular problem in the West Bank. Graduates from West Bank universi- 25X1 ties average about 6,000 a year, and many others

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return from study abroad, but there are no jobs available for them. The Israeli market is closed to them, there are no jobs for their skills in the West Bank, and the recession in the Gulf countries has closed employment opportunities for them there. The bleak job outlook for this group, in our judgment, almost certainly will heighten political tensions.

The problem probably will worsen this summer as Bir Zeit University has announced plans to lay off a number of professors because of budgetary constraints. Other West Bank universities and vocational institutions also are reportedly facing financial problems because of a withdrawal of support by the Jordanian-PLO Joint Committee. The committee itself is not receiving most of its promised aid from the Persian Gulf countries.

The most serious potential problem in the territories would be the return of a large number of the estimated 25,000 Gazans and 50,000 West Bankers currently employed in the Gulf region. While we have no information on the number of Palestinians seeking to return to the territories, the continued recession in the Gulf countries will most likely force many to return over the next two to three years. Press reports have stated that Israel's civil administration that runs the territories is preparing contingency plans to provide jobs for returning Palestinians, but these make-work programs probably will absorb only a few thousand, mainly nonprofessional, workers. Moreover, according to recent press reports, some expatriate workers are being denied entry into the West Bank by Jordanian authorities.

## Reasons for the Decline

While the recession in neighboring countries and the falloff of aid and remittances from the Gulf are the main causes for the economic decline in the territories, these areas also have a variety of other problems. In Gaza, a drought over the last two years has cut into citrus production as Israel has imposed restrictions on water use. Shrinking export markets have also hurt: Israel discourages Gazan citrus exports to Western Europe, competition from Cuba has cut into East European demand, and the Iranian revolution ended exports to Iran. Jordanian import quotas and restrictions on marketing Gazan produce in Israel have further aggravated the situation. 25X1

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Fishing, Gaza's other main occupation, has also deteriorated because Israel—citing security concerns—has limited fishing to a 12-by-24-kilometer offshore zone and placed restrictions on hours of operation. Egypt also has reportedly refused permission for Gazan fishermen to operate in some of its waters. According to press sources, Gaza's fish catch has declined from about 3,800 metric tons in 1968 to 420 tons in the first eight months of 1985. 25X1

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West Bank agriculture, which produces 27 percent of the territory's GDP, also has been hurt by drought over the last two years and by production and marketing restrictions set by Israel and Jordan. Industry, which provides less than 7 percent of West Bank GDP, also faces severe marketing restrictions in these neighboring countries. 25X1

## Politics Complicate the Situation

As with most issues in the Middle East, politics expand these problems beyond their normal dimensions. Typical of the situation is the position of the East Jerusalem Electric Company. Israel recently put this company into receivership for failure to pay its debts to the Israeli Electric Company, from which it was forced to purchase electricity because of a lack of alternative suppliers. Meanwhile, the company sits with four new generating units unconnected to its grid because it lacks permission to install them. The company operates inefficiently, in part, because of featherbedding by a strong pro-PLO union. 25X1

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Jordan refuses to bail out the company for fear that its operations may be taken over by the Israelis after its debts are paid. Jordan would also like to see management and worker reforms in the company; reforms that it would have difficulty monitoring from Amman. Israel would like to find a way to wean away the Jewish settlement areas that the company now serves and to connect these settlements to the Israeli grid.

Other political factors have also hurt the occupied territories. Because of a perceived lack of West Bank political support for King Hussein's peace initiative with the PLO, Jordan reportedly has reduced funds flowing to West Bank municipalities, has clamped down on travel between the West Bank and Jordan, and has frozen some West Bank funds in Jordanian banks. Jordan also does not allow the importation of any West Bank goods produced at factories built in the territory after 1967 or goods manufactured in the West Bank that include any Israeli-produced materials. Jordan also insists that foreign capital goods and materials for any new West Bank investment projects be imported through Jordan.

Israel, for its part, put little money into West Bank infrastructure development until the first Likud government of 1977—and then only to strengthen Israel's connection with Jewish settlements there. Press reports claim that infrastructure development was then on an east-west axis connecting Jewish settlements to the Israeli heartland rather than the natural north-south axis, which would have benefited the Palestinian inhabitants of the West Bank.

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**Outlook**

Jordan has prepared a new five-year development plan for the West Bank that offers some hope for renewed investment and development of the area. Jordan is struggling with its own recession and lack of funds, however, and the East Bank has higher unemployment than the territories. The plan probably will provide only some seed money for West Bank projects. The plan nonetheless suggests that Amman is taking more interest in the area and may be more willing to undertake quiet, cooperative efforts with Israel. Israel, at least under Labor Party Prime Minister Peres, also seems more interested in spurring development in the territories and has recently put more money into support for government hospitals in the West Bank and Gaza. 25X1

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The economic outlook for the West Bank and Gaza, however, is directly tied to that of Israel. As long as Israel sticks with its austerity program, the territories will gain relief from high past Israeli inflation rates, but there will be little likelihood of any economic rebound in the near term. Coupled with probable continued declines in remittances and aid, local unemployment will be increasing at a time when there probably will be more workers returning from the Gulf region. High unemployment among the professional ranks may be especially troublesome as it will create a class of higher educated and disaffected individuals, who may aggravate the political situation in the West Bank. 25X1

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# Briefs

## Energy

*OPEC Production Update*

OPEC crude oil production averaged 18 million b/d in May, a decrease of 400,000 b/d from April levels. Marketing problems forced cutbacks in Saudi Arabia, Kuwait, and Nigeria as OPEC output was crowded out of the market by increased sales from non-OPEC producers. The end of the Norwegian oil strike, which had taken about 900,000 b/d off the market during most of April, and a sales push by Mexico were largely responsible for the boost in non-OPEC output. 25X1

**OPEC: Crude Oil Production, 1986** *Million b/d*

| | First Quarter | April | May |
|---|---|---|---|
| **Total** | **17.8** | **18.4** | **18.0** |
| Algeria | 0.7 | 0.7 | 0.7 |
| Ecuador | 0.3 | 0.3 | 0.3 |
| Gabon | 0.2 | 0.2 | 0.2 |
| Indonesia | 1.3 | 1.3 | 1.3 |
| Iran | 2.3 | 2.3 | 2.3 |
| Iraq | 1.8 | 1.8 | 1.8 |
| Kuwait [a] | 1.3 (1.2) | 1.6 (1.2) | 1.3 (1.2) |
| Libya | 1.0 | 1.0 | 1.0 |
| Nigeria | 1.4 | 1.7 | 1.5 |
| Qatar | 0.3 | 0.2 | 0.3 |
| Saudi Arabia [a] | 4.4 (4.3) | 4.6 (4.5) | 4.5 (4.3) |
| UAE | 1.2 | 1.3 | 1.3 |
| Venezuela | 1.6 | 1.6 | 1.6 |

[a] Amount in parentheses excludes production from the Neutral Zone, whose output is divided between Saudi Arabia and Kuwait and included in their country quotas; the Neutral Zone has no production quota of its own.

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*Possible New Long-Term Mexican Oil Contracts*

PEMEX, the Mexican state oil company, apparently is negotiating new long-term oil export contracts with Taiwan and Belgium. Taiwan's Chinese Petroleum Corporation will take delivery of a trial cargo of 700,000 barrels of Isthmus light crude in late June. The oil will be priced according to the retroactive pricing mechanism used in PEMEX's contract with Japan. PEMEX also confirmed delivery in late May of a trial cargo of Isthmus light crude and Maya heavy crude to Petrofina of Belgium. The price formula for this cargo was probably the one announced in January, linking the price to that of Brent, Flotta, and Urals crude. Mexico's export earnings have been hit hard by declining oil prices, especially because Mexico refuses to use netback pricing for its oil. Long-term export agreements would be attractive to Mexico, both to secure relatively stable levels of exports and provide some security against price fluctuations. [redacted] 25X1

*Canadian Energy Deregulation Fuels Regional Disagreement*

Ottawa's commitment to freeing domestic energy markets will be tested by renewed regional strife over natural gas deregulation. Natural gas prices are due to be deregulated by 1 November, and eastern Canadian buyers are threatening to purchase natural gas from the United States unless deregulation brings sharp price reductions. Albertan producers counter that even the current price inhibits new exploration, and that reductions in provincial tax and royalty rates are needed to offset the price decline consumers expect—a move provincial governments have been reluctant to take without a matching commitment by Ottawa. Ottawa appears torn between wanting to make good on its pledge to deregulate the market on schedule and being sensitive to the problems of the western Canadian economy. Ottawa's attempt to negotiate a compromise between the eastern and western provinces is bound to rekindle federal-provincial animosity, threatening the 1 November date for deregulation. [redacted] 25X1

## International Finance

*Growing Egyptian Financial Plight*

Foreign bank creditors are increasingly concerned that Egypt's lack of cash could precipitate a financial crisis as early as August, forcing Cairo to seek a rescheduling of both commercial and bilateral debts. Egypt's precarious financial position is leading a growing number of banks to reduce their credit lines to the country, according to [redacted] US Embassy reports. 25X1
[redacted] arrearages on short-term credits may already have reached $1.5 billion. The steep drop in oil prices, internal problems in marketing oil, and a general decline in other hard currency earnings have exacerbated Egypt's chronic economic difficulties. Recent talks between Cairo and the IMF, however, have produced little progress on an IMF-endorsed economic adjustment program needed for debt rescheduling. The Mubarak regime almost certainly fears that the public will view IMF-recommended austerity measures as an infringement of Egypt's sovereignty, heightening the risk of further political agitation and violent demonstrations. [redacted] 25X1

*Panama and Creditors Closer to Agreement*

Panama and the World Bank reached tentative agreement in late May on structural adjustments needed to free up $93 million in frozen World Bank, IMF, and commercial bank loans by the end of this year. The tentative accord could pave the way for disbursement of $22 million in suspended IMF funds by the end of the month, according to the US Embassy. Disbursals from the World Bank and commercial lenders, however, hinge on Panama's implementing tough reforms including social security and public-sector privatization—politically difficult issues. If all conditions are met, the World Bank will be able to release up to $50 million of an $80 million Structural Adjustment Loan. The World Bank loan, in turn, will pave the way for the resumption of payments under the existing IMF standby agreement and will also make available $21 million in new money from commercial banks. [redacted] 25X1

*Portugal's Foreign Debt Rises*

Portugal's foreign debt rose 11 percent last year to $16.6 billion. According to the US Embassy, about 80 percent of the increase was due to exchange rate changes, rather than new borrowing. We expect the debt situation to deteriorate in 1986, however, because of Portugal's entry into the EC and the Cavaco Silva government's expansionary economic program. These factors are likely to turn last year's small current account surplus into a deficit of about $500-700 million. This will have to be financed primarily through new borrowing in international capital markets because foreign direct investment is relatively insignificant. Although the foreign debt already equals more than 80 percent of GDP, we doubt that Lisbon will have to resort to additional IMF financing this year. [redacted] 25X1

*Greece Obtains Large Bank Loan*

The success of Greece's $370 million syndicated loan in May was mainly the result of attactive terms rather than increased banker confidence. The loan—Greece's first since the introduction of austerity measures last October—will pay 0.75 percentage point above LIBOR for eight years with a five-year grace period. While many European and US bankers reportedly are uncertain about Athens's commitment to economic reform, they were enthusiastic about the loan's high margin. Several bankers reportedly felt that continued EC financing of Greece, including the $1.5 billion November balance-of-payments loan, also contributed to the syndicated loan's success. Although Athens probably will not meet some of the targets agreed to with the Community, we believe enough improvement will be made to enable the EC to release the second portion of the loan early next year. This, in turn, probably will be enough to keep open Athens's access to the private credit market. [redacted]

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## Global and Regional Developments

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*Italy-Libya Renegotiate Oil Compensation Accord*

Deteriorating relations between Rome and Tripoli probably will undermine Libya's recent agreement with Confindustria, an Italian manufacturers association, to resume payments on nearly $500 million in debts owed Italian firms. In July 1984, Confindustria agreed to accept oil in payment but demanded renegotiation of the terms of the accord this spring after the drop in world oil prices. Under the new terms, oil prices will be set monthly, based on the estimated value of the products derived from the oil. AGIP, Italy's state-owned oil company, will sell the oil for the companies, probably on the spot market. Confindustria expects the oil shipments—suspended since January—to resume this month with a delivery worth $60 million. Oil deliveries, however, have been sporadic in the past—less than $100 million has been paid since the agreement was first signed in July 1984—and Italian firms probably will continue to investigate ways to attach Libyan assets in Italy in case of default. Although the Italian Government was not involved in the negotiations, it probably supports the accord and is likely to seek similar compensation for $200 million in commercial debt owed by Libya. 25X1

*Finland Boosting Soviet Imports*

Helsinki has agreed to increase imports of energy from the Soviet Union to reduce Finland's bilateral trade surplus, but the measures will not help achieve the balanced trade ostensibly required by their longstanding trade agreement. Finland's increased purchases will include 11 percent more electricity and 35 percent more coal worth a total of about $40 million. In fact, Finland's bilateral surplus, now about $300 million, will continue to grow as lower oil prices this year reduce the value of Soviet oil exports to Finland—about three-fourths of the total. The decision to boost energy imports indicates that Soviet attempts to boost exports of machinery and other finished products have been unsuccessful. The 1987 trade protocol will probably tackle the surplus problem by requiring Finland to reduce its exports. The Soviets have, in fact, already canceled some proposed Finnish construction projects in the USSR. Furthermore, Moscow's hard currency shortage diminishes the prospect that it will reduce the surplus by paying for a significant amount of Finnish goods outside the framework of the trade agreement. 25X1

*Tin Producers May Move To Support Prices*

The Association of Tin Producing Countries (ATPC)—Malaysia, Indonesia, Thailand, Bolivia, Nigeria, Zaire, and Australia—may attempt to prop up depressed tin prices in the absence of an effective international tin agreement. Seven months after the collapse of the international tin market, tin prices are hovering around $2.50 to $2.60 a pound—about half their level before the crisis began. Malaysia, which has long urged the ATPC to intervene in the market, has recently stepped up calls for producer cooperation on prices. The ATPC is also sending delegations to urge cooperation by nonmembers Brazil and China—which together represent almost one-fifth of world tin exports, up from just 4 percent in 1980. Without their support, an ATPC price support effort would almost certainly fail. Low-cost-producer Brazil is unlikely to favor production controls, however, because it is seeking to expand tin exports. 25X1

*Western Europe's Arianespace Problems*

The West European Arianespace enterprise was already having problems before the failure on 31 May of an Ariane launch vehicle—the fourth failure in 18 attempts. production problems at Ariane's rocket engine supplier and delays in computer analyses of past launches have slowed the launch schedule. Launch prices were raised 30 to 35 percent in January to offset the effects of the falling dollar—Ariane prices its services in dollars—and to help solve cash-flow problems. Arianespace's latest failure will crimp its aggressive marketing campaign. Because launch capability in the West is now severely restricted, customers needing to orbit payloads quickly—such as India and Indonesia—may request COCOM waivers for their new satellites and have China or the USSR provide the launch. Because of expected increases in insurance premiums, the cost of investigating the launch failure, and longer launch preparation times, Arianespace will probably have to seek additional subsidies from the European Space Agency and the French space agency (CNES). 25X1

*Continued Decline in Arab Aid Last Year*

Commitments from eight major Arab aid institutions fell almost 20 percent in 1985 to $1.6 billion, according to press reports. Following four consecutive yearly declines, aid flows are now only about 55 percent of the $2.8 billion peak level reached in 1981. Arab countries such as Jordan, Morocco, and Sudan have absorbed the largest cuts. We expect that Arab aid will fall again during 1986 as major donors further reduce allocations as part of austerity policies. [redacted] 25X1

**Arab Banks and Development Institution Aid, 1982-85** *Million US $*

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| **Total** | **2,634** | **1,949** | **1,915** | **1,574** |
| Islamic Development Bank | 520 | 571 | 837 | 672 |
| Saudi Fund for Development | 611 | 372 | 352 | 372 |
| Kuwaiti Fund for Arab Economic Development | 763 | 390 | 253 | 214 |
| Arab Fund for Economic and Social Development | 233 | 310 | 283 | 176 |
| Others [a] | 507 | 306 | 190 | 140 |

[a] The Abu Dhabi Fund for Arab Economic Development, OPEC Fund for International Development, Iraqi Fund for External Development, and Arab Bank for Economic Development in Africa.

[redacted] 25X1

*Toyota To Challenge South Korea in US Small Car Market*

According to a Japanese press report, Toyota Motor Corporation will begin to export next January a redesigned low-priced subcompact to compete in the US market with South Korean cars. Toyota plans to reverse a three-year trend during which exports of its lowest priced cars slid as sales of up-market, higher profit vehicles increased. The move underscores Japan's desire not to surrender its share of the low-end car market to Hyundai Motor Company and other manufacturers that will be entering this market in the next few years. Toyota will still be able to stay within its export quota, despite increased shipments of its lowest priced model, by reducing exports of a vehicle that will soon be produced at its joint-venture plant in the United States. [redacted] 25X1

## National Developments

### *Developed Countries*

*Ottawa Rejects Call To Boost Currency*

Ottawa rejected Treasury Secretary Baker's suggestion that Canada appreciate its currency as the price of admission to the Group of 7 (G-7). Finance Ministry officials believe the G-7 should be used to help coordinate economic policy, thereby reducing exchange rate volatility, not to impose policy on its members. Consequently, Ottawa almost certainly will continue to stabilize the dollar in the US 71- to 73-cent range. This position is strongly supported by many Canadian manufacturers who believe the current exchange rate is crucial to maintaining Canadian competitiveness in the US market. Ottawa may even accept a weaker Canadian dollar in the coming months to spur Canadian economic growth. [redacted] 25X1

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*Japanese Economic Growth Slows*

According to the US Embassy, the Japanese Economic Planning Agency (EPA) last month privately lowered its projection of economic growth to 2.6 percent for FY 1986, which began on 1 April. The revised forecast, which largely reflects the deflationary impact of the strong yen, is well below the 4.6-percent rate recorded last year. We believe that Tokyo's official projection of 4 percent is now too optimistic although the EPA projection rate may be low. Despite the mounting evidence of a slowing economy, Tokyo is unlikely to lower the official forecast before general elections on 6 July. Many Japanese specialists consider 3 percent to be the minimum politically tolerable growth rate. EPA researchers also believe the new forecast clearly supports calls by some Japanese politicians and business leaders for a substantial pump-priming package this fall. [redacted] 25X1

*Falling Profits for Japanese Automakers*

The financial reports of the Japanese auto industry indicate the damage that yen appreciation is inflicting on company profits. Honda Motor Company, while able to achieve an increase in profits for its fiscal year, saw earnings fall sharply in the final quarter that ended in February. Nissan and Mitsubishi, which ended their fiscal years one month later, announced profit declines of about 16 percent for the year. The Japanese press reports that Toyota is estimating a 30-percent decline in earnings for its fiscal year ending 30 June. Thus far, Japanese automakers have been willing to offset only about one-third of the yen's appreciation by raising their US prices. While further price increases will likely close some of this gap, we expect the deterioration in profits to continue. Toyota and Nissan, for example, have projected fiscal 1986 profits as much as 50 percent below their already reduced 1985 earnings.

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*Greek Current Account Improves*

The Greek current account deficit in the first quarter narrowed to $874 million—nearly one-fourth below the first-quarter 1985 level—because of lower oil prices and a temporary increase in EC transfers, rather than the austerity measures introduced last October by Prime Minister Papandreou. The trade deficit fell 8.2 percent because of a slight increase in exports and a 4.4-percent decrease in imports. Lower oil prices saved Greece about $200 million in the first quarter, while nonoil imports actually rose 6 percent, despite import restrictions, a 15-percent devaluation, and a tighter incomes policy. Invisible earnings rose by 20 percent in the first quarter, due mainly to a 106-percent jump in inflows from the EC. For the full year, however, EC inflows are expected to remain near the 1985 level of $850 million. With high Greek inflation rapidly eroding the impact of the October devaluation, we believe Athens has little chance of holding the 1986 current account deficit to the target of $1.7 billiion.

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*Bad Economic News in South Africa*

Growing labor unrest, continued violence in the townships, and consumer boycotts have sapped business confidence and undermined Pretoria's efforts to stimulate the economy. Preliminary data for the first quarter of this year indicate that GDP fell despite higher gold prices, improved rainfall, and a rescheduling of short-term foreign debt. In an effort to rekindle economic activity, Pretoria has pushed real interest rates to a record low of negative 4 percent and budgeted a modest increase in government spending. Recent surveys indicate business confidence has declined sharply this year and was at a near-record low in May. The rand has fallen to 40 cents, a 20-percent decline since March. Capital outflows have totaled about $1 billion this year, and some foreign investors are divesting their holdings despite penalties on capital transfers. Black labor unrest and consumer boycotts have increased dramatically since the beginning of the year. In the mining sector, the number of strikes through May already exceeds the total number of strikes in 1985. Gold production, which accounts for half of export revenues, was down by 6 percent in the first four months, compared with the same period last year. The government was hoping for a 3-percent increase in real GDP this year after a 1-percent decline in 1985. Despite favorable conditions for a robust recovery, however, real GDP will grow, at most, by 1 to 2 percent, and fixed investment almost certainly will decline for the fifth consecutive year.

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*Bank of Israel Governor Resigning*

According to the US Embassy, Prime Minister Peres accepted the resignation last week of Bank of Israel Governor Mandelbaum. No replacement has been named, but the successor is likely to come from the Labor Party under an informal arrangement between Labor and Likud. Mandelbaum was under increasing pressure to resign after a government-appointed investigatory committee implicated him in the bank share scandal and subsequent stock market collapse of October 1983. Mandelbaum's resignation follows the earlier resignations of several other banking industry officials, who also stepped down because of their involvement in the stock market scandal.

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*Israeli Cotton Worries*

Already hurting from a continuing decline in local consumption and an increase in outside competition, Israel's cotton producers are being driven deeper into the red by the weather. Because of this year's drought, the Israeli Government has doubled the price of water to 10 cents per cubic meter and recently announced it will cut water for agricultural use by more than 12 percent. The 65,000 hectares planted in cotton account for about 55 percent of Israel's land under irrigation and use about one-third of Israel's annual water supply, but account for only about 9 percent of the value of Israel's annual agricultural production. Despite the government's provision of a $30 million subsidy earlier this year, major decreases in cotton land, especially in the more arid south, are likely. 25X1

***Less Developed Countries***

*Brazil's Inefficient Parastatal Enterprises*

Recent US Embassy reporting indicates that inefficient state companies continue to impose a significant drain on government coffers, jeopardizing the ability of the Cruzado Plan to quash inflation. Brasilia supports its money-losing parastatals—only four of the top 30 operate in the black—for political reasons to substitute for imports, earn foreign exchange, and keep up employment. For example, the publicly owned copper smelter lost $55 million last year, despite charging prices 80 percent above international levels. Nevertheless, the administration plans to expand copper output from 90,000 metric tons last year to 150,000 tons by 1988, according to US Embassy reporting. President Sarney has promised to sell off money-losing state firms in response to criticisms of the persistent public deficit—equal to 3.8 percent of GDP last year. This year's deficit may equal that of 1985. We believe large cutbacks are unlikely with congressional elections approaching in November.

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*Saudis Revalue Assets*

The Saudi Arabian Monetary Agency announced last month that it has "found" $17 billion after recalculating its assets, now worth a total of approximately $90 billion. [redacted] Riyadh revalued its assets to reflect market value rather than book value. In addition, Saudi liquid assets—some $64 billion at the end of 1985—may have increased in value by as much as $11 billion because of a decline in US interest rates and the depreciation of the US dollar. Riyadh has tinkered with reserve figures in the past to achieve political objectives, and its announcement may be intended to show that the oil price decline has not significantly weakened Saudi finances. Even so, Riyadh continues to draw down assets to cover its budget deficit, and, even with the additional cushion, reserves would be depleted in less than five years if the government continues to tap reserves at current rates. [redacted] 25X1 25X1

*Limited Economic Reform in Uganda*

President Museveni has struggled during his first five months in power with the reconstruction of Uganda's war-ravaged economy. According to US Embassy reporting, however, last week the government announced only a few relatively minor policy adjustments, including modest increases in producer prices of key export commodities and in interest rates and the reestablishment of a two-tiered exchange rate. Nonetheless, the US Embassy reports that the new prices for coffee and tea are still too low to discourage smuggling, while real interest rates remain negative. In addition, efforts to redress previous regimes' fiscal mismanagement were limited to increasing control over official travel, reducing Ugandan diplomatic presence abroad, and reviewing parastatals for possible privatization. The government's poor policy performance probably reflects a widespread lack of economic expertise in the leadership, as well as a general distaste for "IMF type" reforms. As a result, serious shortages of foreign exchange and basic goods and annual inflation above 100 percent are likely to persist. Museveni's failure to adopt more significant economic reforms may also jeopardize national unity by aggravating ethnic factions' dissatisfaction with the lackluster economy. [redacted] 25X1

*Pakistan Announces New Budget*

Pakistan's first post-martial-law budget announced on 29 May attempts to promote populist issues—job creation, higher minimum wage and pension benefits, lower prices on selected petroleum products, and increased agricultural credit. The purpose is to deny the opposition, primarily Benazir Bhutto's People's Party, a rallying point. According to the US Embassy, the budget—estimated at $9.2 billion—includes no new taxation measures. Instead, the government will rely heavily on profits generated from the domestic sale of oil purchased at low prices. Nonetheless, it probably will bow to pressure from consumers and pass on even more of the savings from lower oil prices, which will lead to a larger-than-anticipated budget deficit. The government also has eliminated an export rebate scheme, which in the past was one of the largest subsidy items in the budget. Growing inflationary pressure resulting from a serious budget deficit, the recent government decision to allow the rupee to depreciate, and the likelihood of lower workers' remittances could quickly undermine living standards and leave the government with less popular support. [redacted] 25X1

*Pakistan Completes Islamic Banking System*

Pakistan has completed the transition to Islamic banking, which began over a year ago, with the establishment of banking tribunals late last month. According to the US Consulate in Karachi, the tribunals will provide banks with a legal recourse against defaulting clients under the interest-free financing system. One of the problems facing Islamic banking has been the slow process of collecting on bad loans. Press reports indicate there are about 42,000 outstanding bad loan cases valued at $200 million. While the functions of the tribunals are still not clearly defined, professional bankers in Pakistan hope they will establish greater discipline in Islamic banking. 25X1

*Malaysia Easing Economic Restrictions*

Prime Minister Mahathir acknowledged last week that Malaysia's weak economy is forcing his government to relax its longstanding policy of encouraging equity ownership by ethnic Malays. He promised encouragement for foreign investors, including the possibility of total foreign ownership rather than the current maximum of 51 percent. Mahathir also hinted that he would delay calling general elections, anticipating an economic recovery by the end of the year. Mahathir was only confirming a policy shift that has been apparent since the downturn began last year. His typically candid comments, however, almost certainly will cause him trouble in the Malay community. The economy is unlikely to improve significantly this year, especially if prices for primary commodities remain depressed. Delaying general elections, which must be held by April 1987, will only add to the reaction against Mahathir's administration, which has had to deal with several financial scandals and charges of corruption in addition to the faltering economy. 25X1

*Insider Criticizes Jakarta's Reform Efforts*

Criticism by a leading government economist of Jakarta's recent efforts to boost nonoil exports is, in our view, also an attack on vested political interests opposed to genuine and effective economic reform. According to US Embassy reporting, the official privately described the so-called May 6 Package—which allows the purchase of imported raw materials not available domestically at competitive prices—as "halfhearted," arguing that, because the bureaucrats determine what is available and price competitive, the result will be more delay, waste, and corruption. He also lambasted Jakarta for its policy of granting exclusive import licenses, claiming that such monopolies hurt the country's ability to compete internationally by restricting competition and encouraging monopolistic pricing. The blame for these moves, he claims, lies with politically influential economic nationalists—such as Minister of State and State Secretary Sudharmono—who favor import substitution and complete protection of domestic industry. At present, the protectionists appear to have President Soeharto's backing and, as a result, the upper hand in determining economic policy. 25X1

## *Communist*

*Soviet Grain Prospects Favorable*

Meteorological data [redacted] indicate that serious crop damage from hot, dry weather in May was confined to areas that altogether produce less than 10 percent of the harvest. Spring sowing is approaching completion on schedule, according to Soviet data released last week. The data suggest, however, that the downward trend in sown area that began in the late 1970s is continuing. If the weather is normal through July, the Soviet winter grain crop—roughly one-third of the total harvest—is likely to be about 61 million metric tons, the same as the US estimate for last year. Recent showers east of the Urals, the main region for spring grain, should ensure good emergence of plants and early growth. If favorable conditions continue over the next three months, the grain harvest could match or exceed last year's total of 196 million tons despite the somewhat smaller sown area. [redacted] 25X1

25X1

[redacted]

25X1

*Large Soviet Blast Furnace Begins Operation*

The world's largest blast furnace—at the Cherepovets Metallurgical Plant—has been observed in initial operation. When fully operational—with computer controls and extensive pollution equipment—the furnace will be able to produce up to 4.5 million metric tons of pig iron per year. According to Soviet open sources, the Cherepovets furnace was the second largest investment project for the Eleventh Five-Year Plan (1981-85), after the Baykal-Amur Railway. The project fell behind schedule because of uncoordinated plans and disorganized management. The Soviets are planning to build only two more new blast furnaces in the Twelfth Five-Year Plan (1986-90)—both smaller than the new one in Cherepovets. To maintain production, they will be reconstructing old furnaces and trying to assimilate Western direct reduction technology that eliminates the need for blast furnaces. [redacted] 25X1

*Chinese Nuclear Delegation To Visit USSR*

The Chernobyl' accident has not dissuaded the Chinese from discussing peaceful nuclear cooperation with the USSR. According to a Soviet Embassy official in Beijing, China will send a nuclear delegation to the USSR later this month for a three-week visit. The trip, initially agreed to last March, will include visits to several nuclear plants and a briefing on Chernobyl'. China's Vice Premier Li Peng described the visit as "purely technical" and noncommittal. Budget and foreign exchange constraints have forced China to cut back nuclear plant imports, but the Nuclear Ministry has upgraded plans for a domestically built plant at Qinshan, near Shanghai. China has already purchased equipment for this plant from West Germany (coolant pumps), Japan (the reactor pressure vessel), and Sweden (tubing), but may consider Soviet participation in expanding the project. 25X1

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